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**The New Market for Tax Insurance:
Insuring Legal Uncertainty or Enabling Tax Avoidance?**

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Abstract

In one sense, this is an article about legal uncertainty and the role that private and public insurance can play in managing it. Somewhat more narrowly, it is an article about tax law enforcement and the familiar if ill-defined distinctions between tax evasion, tax avoidance, and “abusive” tax avoidance. Most narrowly, the article is about a new type of insurance policy, called tax indemnity insurance (or transactional tax risk insurance), which provides coverage against the risk that the IRS will disallow a taxpayer-insured’s tax treatment of a particular transaction. The question is whether this type of insurance coverage increases incentives for illegitimate tax avoidance or, alternatively, provides needed certainty to taxpayers. Should tax insurance be banned? Encouraged? Ignored? And what about insurance against other types of regulatory uncertainty? To what extent should the government, instead of commercial insurance companies, provide such legal-uncertainty insurance directly? On the narrow question of tax indemnity insurance, the article concludes that the appropriate regulatory response is probably (a) to allow the policies to be sold but (b) to compel disclosure to the IRS by taxpayers who purchase such policies.

Introduction

Imagine an individual who is trying to decide whether or not to rob a bank. Or better yet, suppose he is contemplating some sort of white-collar crime such as embezzlement, insider trading, or – most interestingly for present purposes – criminal tax

evasion. He has weighed all of the disadvantages, including the probability of capture, the likely severity of the punishment (the potential jail time as well as the prospect of monetary fines), the informal sanctions from his community, and the guilt and shame he would feel for having become a criminal. And those costs are considerable. But so are the benefits: the money, the thrill of sticking it to The Man, the money. In fact, what sets this person apart is that he finds himself just barely – or, to use the economist’s term, marginally – on the law-abiding side of the line.

Now introduce the admittedly preposterous but theoretically useful idea of crime insurance for criminals, what I will call *criminal liability insurance* for perpetrators. Specifically, imagine that our marginal law-abider encounters an especially entrepreneurial insurance agent, who makes him the following intriguing offer: “I understand you’re thinking of engaging in some ‘questionable’ business activities. Don’t worry. I’m not with the FBI. In fact, I represent an insurance company that happens to sell a policy to cover the monetary risks associated with just these sorts of activities. The product we offer would cover you, for example, against the possibility that your activities will be discovered and that you will ultimately be forced to pay restitution as well as other and civil or perhaps criminal fines. The policy does not cover all crimes, of course, only the specific ones that we pre-approve, crimes that meet the standards set by our crack panel of law-enforcement experts, which consists of former prosecutors as well as former (and current) criminals. Nor does it cover crimes against yourself – such as burning your own house down. (Insurance companies wouldn’t last long selling first-party intentional harm insurance.) Moreover, and this should be obvious too, we cannot insure you against the possibility that you might go to jail; that is a risk you will have to

bear yourself. But the *financial* risk associated with these specified crimes against other, including the cost of your legal defense, those we can insure. All of this coverage, of course, will be subject to a co-payment (to help align your incentives with ours) and an overall policy limit (to help us price the coverage). But besides those qualifications, much of economic risk and uncertainty of the ‘transactions’ can be shifted to us – for a premium, of course.”

If such insurance were available, it would of course be a deterrence nightmare. Marginal law-abiders would be induced to break the law. Individuals already embarked on a life of crime would, with the introduction of criminal liability insurance, be willing to take even greater chances and increase the scale of their criminal enterprises, given that some of the financial risks of doing so could be shifted to the insurer. Depending on the number of marginal law-abiders out there, and on their level of risk aversion, criminal liability insurance could create an enormous externality on society in the form of a dramatic increase in the frequency and severity of economic crime. In response, law-enforcement officials would have to rely less on financial penalties (which would increasingly be insured) and more on uninsurable non-monetary sanctions such as stiffer jail sentences. The problem is that jail-time may not always be a good substitute for monetary penalties. Thus, crime rates, at least financial crime rates, would likely rise – or cost more to keep from rising. All of this is why criminal liability insurance does not in fact exist, at least not insurance for perpetrators who intentionally violate the law. Yet insurance certainly *is* available and widely purchased to cover the monetary costs of *accidental* breaches of legal standards. Indeed, that is one of the main functions of run-of-the-mill liability insurance: to cover individuals and firms against the risk of becoming

legally obligated to pay damages as a result of their *negligent* behavior. What's more, sometimes standard liability insurance policies are interpreted to cover certain types of criminal prosecutions and criminal fines, if the crime in question involves something less than intentional wrongdoing.¹

The central question this Article explores is where tax insurance fits into this picture. Tax insurance policies – sometimes called *tax indemnity insurance policies (TIIPs)* or *transactional tax risk insurance* – provide taxpayers with coverage against the risk that the IRS will reject a taxpayer's characterization of a particular transaction on its tax return. The typical tax insurance policy provides full indemnification for all tax-related losses, including back taxes, interest on those back taxes, as well as penalties. Moreover, these policies also tend to cover the insured-taxpayer's legal costs associated with litigating their case against the government. Tax-insurance promoters contend that tax indemnity coverage eliminates much of the legal uncertainty faced by corporate managers with respect to how the IRS or the courts will interpret the tax laws to apply to particular factual situations. Without this certainty, they contend, socially desirable (wealth creating) corporate transactions may not take place; that is, the risk of an adverse determination by the IRS and the added possibility of penalties may be enough to kill the deal. In addition, they argue that tax insurance provides a social benefit by, in effect, enlisting insurance companies in the job of policing and discouraging tax-shelter transactions. Specifically, they argue that tax insurance serves the purpose that private letter rulings once did but no longer do. Finally, they contend that tax indemnity insurance is never written to cover outright "tax evasion" or, for that matter, "tax shelter

¹ This can be true in cases in which the crime requires only negligently caused harm on the part of the insured and in which the penalties are fines. [cite to environmental criminal statutes and insurance policies covering violations].

transactions” or other forms of “abusive tax avoidance” and thus are not a tax-enforcement concern; but rather that the sale of such policies by “conservative” insurance companies helps to create a “culture of compliance” among corporate taxpayers. Although the information on this is only anecdotal, by some accounts tax insurance is a rapidly spreading market among corporate taxpayers.²

When I describe this new type of insurance to other tax academics, however, their responses are almost uniformly negative. Indeed, I have yet to encounter a tax scholar who does not regard tax indemnity insurance at least with deep suspicion, and many think it should be limited or even banned. Given the scholarly attention that has been devoted in recent years to the problem of proliferating and increasingly aggressive corporate tax shelters and the problem of rampant tax noncompliance more generally, perhaps this reaction should come as no surprise. It seems as if an increasing number of taxpayers are deciding to play the “audit lottery” and take aggressive (if not clearly illegal) positions on their tax returns in the hope that they will never be caught. What we need, everyone seems to agree, are much stiffer penalties for tax noncompliance and more resources devoted to auditing; the *last* thing we need is a new financial product that enables aggressive taxpayers to shift their audit risk to a risk-neutral insurer! Thus, the argument concludes, although tax indemnity insurance may currently be a small-scale phenomenon, it could become much larger and thereby make an already difficult tax compliance problem much worse.

So who’s right? If we take seriously the claims of tax-insurance promoters, there is indeed a surprisingly strong case for allowing, even encouraging, tax risk insurance.

² See, e.g., Kenneth A. Gary, “New Opportunity for Tax Lawyers: Insuring Tax Transactions,” 104 Tax Notes 26, July 25, 2004 (describing rapid recent growth of tax insurance market).

However, if they are wrong (and there are obvious reasons to doubt their objectivity on this issue), a possibility exists that tax indemnity insurance could move in the direction of insuring tax shelters, which means a step in the direction of insuring illegal (or impermissible), though perhaps not yet criminal, activities. Therefore, one of the interesting questions raised by the appearance of tax indemnity insurance is whether it is more like commercial liability insurance, and therefore should be considered on balance a socially beneficial or at least socially benign development, or whether it is more like criminal-activity insurance, in which case it should be discouraged or banned altogether. But perhaps the more interesting question is the more general one: What in principle distinguishes the (hypothetical) criminal liability insurance policy from the standard commercial liability policy, making the former both illegal and nonexistent and the latter both legal and commonplace? The answer, interestingly, turns out to involve the well-known distinction between rules and standards and the related, if much less well known (indeed, as far as I know, original to this Article), distinction between two different types of risk or uncertainty that are covered under the typical liability insurance policy: “substantive legal uncertainty” (which might also be called “merits risk”) and “detection risk” (which, in the tax context, might also be called “audit risk”).³ One of my arguments is that these distinctions help us to understand, as well as to draw prescriptive and descriptive conclusions about, various types of liability insurance, including tax indemnity insurance.

³ For the most part, in this essay I treat the concepts of risk and uncertainty as being equivalent, although I realize there is a technical distinction that can matter in certain contexts. [cites to Frank Knight and recent cognitive research on distinction between risk and uncertainty.] My colleague David Hasen suggested the term “merits risk” to me, and I like it.

Part I begins with a description of the problem of tax law enforcement, the distinction between tax evasion, tax avoidance and the link between those concepts, the rules/standards debate, and the market for tax insurance. Part II then describes briefly what I call the “old market” in tax insurance, the widespread and uncontroversial phenomenon of warranties or guarantees issued by tax-preparation firms to individual and small-business taxpayers. Part III provides a somewhat more detailed description of the tax indemnity insurance market, what (ostensibly) motivates it, and why that market has arisen now. Part IV gives fuller voice to the worries that one might legitimately have concerning a market for tax insurance, given the already serious deterrence problems in the area of corporate tax enforcement. That Part, however, also explains in greater detail the somewhat surprising case in favor of allowing its use in certain settings and explores the question whether there is any significant difference between tax indemnity insurance and commercial liability insurance such that the former ought to be restricted or banned whereas the latter is not only allowed but encouraged. Part IV also briefly outlines some steps that tax policymakers might take to minimize the dangers and maximize the advantages of tax indemnity insurance – that is, to minimize the possibility that it will be used cover only detection risk. Finally, this Part considers an alternative to commercially provided legal uncertainty insurance – government provided legal uncertainty insurance. The idea would be to enable the IRS in effect to sell *ex ante* ruling requests to individual and corporate taxpayers for a fee (or a “premium”), which would be the equivalent of government provided tax-indemnity insurance. There some advantages and some disadvantages to this approach, which I discuss below. I also suggest some more general lessons regarding the choice between commercial and government-provided insurance

against legal uncertainty. [Note to Readers: This last section in Part IV comparing the IRS and commercial insurance companies as legal-uncertainty insurers is yet to be written. But we can discuss the idea, if there is time.] Part V concludes.

I. Evasion and Avoidance, Rules and Standards, and the Problem of Legal Uncertainty

The Problem of Tax Noncompliance

There is an obvious sense in which tax compliance is a permanent law-enforcement problem. As with the enforcement of any law that imposes individual burdens for the collective good (of which tax law is the quintessential example), incentives for free riding will always be present. In the tax context what this means is that taxpayers, individual and corporate, will always have an incentive to minimize their own tax liabilities while, of course, continuing to take full advantage of the benefits of government expenditures.⁴ A corollary of this fact is that, in the absence of penalties for non-compliance, funding government expenditures through taxes would be highly problematic. This is not to say, of course, that informal sanctions, such as social norms, play no role in encouraging tax compliance, nor that tax compliance would be nonexistent in the absence of sanctions. To the contrary, there is considerable evidence that taxpayers voluntarily pay more in taxes than formal deterrence models would predict.⁵ In fact, given how many individuals and firms *do* pay their taxes, it seems reasonable to assume either that there is a fair amount of cognitive failure (or perhaps altruism or patriotism) on the part of taxpayers or that the informal sanctions taxpayers face (such as the reputational costs of being labeled a “tax cheat”) are a more significant

⁴ Give latest numbers of “compliance gap.”

⁵ cites

deterrent than one might initially think.⁶ Still, few doubt that the traditional deterrence factors – the probability of detection and the magnitude of the penalty – remain tremendously important in the compliance equation for many taxpayers. And this seems especially true for most if not all sophisticated taxpayers, by which I mean taxpayers – corporations and wealthy individuals (as well as partnerships and trusts through which wealthy individuals often invest) – who hire expert tax advisers to help them arrange their financial affairs so as to minimize their taxes.

An important question, then, is whether the current deterrence variables are set at the socially optimal level. Few tax experts think so. That is, most would argue for some combination of increased audits and increased penalties and perhaps both. Indeed, there is a widely held view among tax academics that, largely owing to the relatively low probability of detection (the so-called “audit lottery”) and the puny existing penalties for tax noncompliance, an increasing number of corporations and wealthy individuals are engaging in highly aggressive tax-avoidance transactions, often referred to as tax shelters, that lack any significant economic substance, have no discernible business purpose other than tax avoidance, and, although based on literal interpretations of the Internal Revenue Code, produce tax outcomes that any reasonable person would agree are inconsistent with sound tax principles.⁷ Moreover, some of us also worry that this highly publicized spread of sophisticated tax avoidance activity on the part of corporate and wealthy taxpayers will

⁶ Indeed, this is why scholars who study the tax-compliance problem have gone from using a simple Beckeresque deterrence framework, in which the level of compliance is modeled as a function (almost) entirely of the probability of detection and the magnitude of the penalty, to using more complicated models that take other factors into account as well. There is also some experimental evidence that suggests that, with respect to some taxpayers (and some types of tax compliance), formal and informal sanctions work not as complements to but as substitutes for each other, such that increasing the formal penalties for tax noncompliance could actually reduce compliance.

⁷ Cite to recent tax shelter literature.

undermine the average individual taxpayer's respect for the system and thus lead to increased noncompliance at every level.

Tax Evasion and Tax Avoidance

I have been speaking as if the terms “compliance” and “noncompliance” have self-evident meanings. They do not. Indeed, one of the biggest problems in tax enforcement is that these terms are not self-defining and often mean different things to different people, a fact that has consequences for designing an optimal tax-enforcement regime and, interestingly, for the issue of tax indemnity insurance as tax insurance is available (and perhaps ought to be available) for some forms of noncompliance but not others. So what is meant by tax noncompliance? For starters, a distinction is often made between “tax evasion” and “tax avoidance,” although the distinction is (to tax experts anyway) notoriously fuzzy. In the simplest terms, evasion is understood to mean the intentional or knowing violation of the tax code. With tax evasion, therefore, the taxpayer has no plausible argument that her position is consistent with the law; moreover, in most cases that get characterized as evasion, the taxpayer is aware of this fact.⁸ A quintessential example of tax evasion, then, would be the intentional failure to report items of income. So, it is tax evasion when a self-employed individual leaves income off the books in order to avoid taxation.⁹ Likewise, when an individual or taxable entity deducts expenses that are clearly not deductible according to the law, or takes deductions for purely fictional expenses, that too would be tax evasion. Also, if a wealthy individual

⁸ Of course, the old “ignorance of the law” adage technically applies to taxes as well, so that having a sincere subjective belief that an activity is legal under the tax laws is not an excuse for tax evasion. In practice, however, unsophisticated taxpayers sometimes are allowed to avoid criminal punishment if they can demonstrate good faith belief in the position they were taking or good faith reliance on tax counsel. There are some tax positions, however, such as many tax-protester arguments, which are so obviously contrary to law – and have been struck down so many times before – that claims of good faith reliance are not taken seriously.

⁹ Often tax evaders facilitate such off-the-books transactions by insisting on payment in cash only.

hides income in a foreign bank account in a manner that is clearly not allowed by U.S. tax law, that taxpayer too is engaging in tax evasion. A conviction for tax evasion, being a criminal offense, can result in the perpetrator's not only having to pay back taxes, interest, and substantial civil and criminal penalties, but also having to spend some time in jail. As I discuss more fully in Part III below, no tax insurance policies cover tax evasion defined this way.

If tax evasion is defined as the clear (and usually intentional) violation of the tax code in order to reduce one's tax liability, what is tax avoidance? An obvious possibility suggests itself: Why not define tax "avoidance" as arranging one's affairs to minimize one's taxes in a manner that is consistent with the governing tax laws. Or as doing everything within the law to reduce your tax liability?¹⁰ This definition would set up a nice dichotomy between evasion (illegal) and avoidance (legal) and would thus simplify the job of the tax enforcer and the scholar. Moreover, just as there are obvious examples of tax evasion, there are obvious examples of legal tax avoidance as well. For instance, it is clearly legal avoidance when a taxpayer takes advantage of a so-called tax-expenditure provision. Tax expenditures are code provisions intended by Congress to provide subsidies for certain types of transactions.¹¹ So, whether it is investing in tax-exempt bonds or investing in property subject to accelerated depreciation, the term legal tax avoidance would fit. But legal avoidance is not limited to tax expenditures. It could also include some (though not all) investments that exploit the tax advantages inherent in the

¹⁰ use Hand quote here

¹¹ This is not to say, of course, that illegal tax avoidance cannot involve tax expenditure provisions. Arbitraging one tax expenditure against another, or a structural aspect of the Code against a tax expenditure, have been common ways of achieving questionably legal avoidance. [discuss shelters of 70s and 80s]. I am not in this Article taking a position on the usefulness of the distinction between tax expenditures and structural provisions in the Code. My only point is that there are some easy cases of legal avoidance.

structure of the tax laws. An example of this would be a simple purchase of growth stock in order to get the benefit of the realization doctrine, as well as the preferential capital gains rate.¹² In any event, what unifies all of these examples is that, whether or not one considers the tax provision in question to be good or bad tax policy (and there is much debate on that question), there can be no doubt that many of the transactions that exploit these provisions were both contemplated and intended by Congress and are undoubtedly legal.

Unfortunately, the neat dichotomy between illegal evasion and legal avoidance does not encompass all of the possibilities. Indeed, the fact that we can identify clear examples of illegal evasion and legal avoidance does not mean that there are no close cases. To the contrary, as every tax practitioner and tax commentator knows (and as students in the introductory federal income tax course struggle to understand), there are many close cases; and distinguishing between what is legal and what is illegal (or what is permissible and impermissible) in the tax area can be extremely difficult. Determining, for example, whether a given transaction is better characterized as abusive avoidance, aggressive avoidance, or just plain legal avoidance, or whether it is instead criminal evasion, can be an extremely difficult exercise. The problem, of course, is that these categories are not distinct from each other at the margins. Rather, there is a continuum with criminal evasion at one end and obvious compliance at the other. And although it is simple enough to tell one end of the continuum from the other, distinguishing between intermediate positions can be next to impossible.¹³ Understood this way, it should come

¹² Of course, abusive tax shelters also often involve exploitation of certain structural elements in the Code. The point here is that some of the tax savings due to the structure of the Code are clearly legal.

¹³ Just as it is easy for a law professor to distinguish an “A” exam from a “C” exam, but separating the “A-” from the “B+” can be excruciatingly difficult.

as no surprise that there is a large class of transactions that are neither clearly consistent nor clearly inconsistent with the tax laws. Indeed, these transactions occupy the vast middle space along the compliance/noncompliance continuum and are, in a sense, the most problematic – and the most interesting subject of study. This is because these transactions present what I call *substantive legal uncertainty*, uncertainty as to what the law actually is or, put differently, how it will be applied by the ex post adjudicator to a given factual situation. (Again, we might also call it “merits risk,” as in the chance that the regulator or court will rule against the taxpayer “on the merits” in the event a transaction is challenged.) And this substantive legal uncertainty, as we shall see, is at least one of the motivations for standard liability insurance as well as tax insurance. The problem, of course, is that, as we move along the continuum away from obviously permissible transactions, what starts out as legal uncertainty insurance can begin to have properties similar to criminal liability insurance of the sort described in the introduction.

Rules and Standards in Tax Law

That there can be significant substantive legal uncertainty in the tax laws may come as a surprise to nonexperts in the field. After all, the tax system is the quintessential rule-based, as opposed to a standards-based, legal regime. And almost by definition there is supposed to be less substantive legal uncertainty with a system of rules than with a system of standards. In fact, however, although the tax system is primarily a system of rules, it is also, as some scholars have recently begun to emphasize, a system of standards.¹⁴ This is because, even in a system with highly complex rules (in fact, perhaps especially in such a system), there can be difficult questions of how the rules are to be applied to complex transactions.

¹⁴ cites

The rules-standards distinction in law is well known. With rules, the lawmaker (such as Congress or agency as rule promulgator) determines *ex ante* – that is, before the conduct being regulated takes place – precisely what conduct is permitted (or compelled) under particular circumstances. Thus, the only question to be answered by the *ex post* adjudicator of rules (be it jury, judge, or agency as rule enforcer) is a factual one: Was the rule violated or complied with? With a standard, by contrast, the lawmaker articulates a general, somewhat vague legal norm and then leaves the precise definition of what conduct is permissible or required, as well as the factual issue of compliance with the norm, to be determined by the adjudicator *ex post*, or after the occurrence of the regulated activity. The classic illustration of the rules-standard distinction involves traffic safety laws.¹⁵ A traffic-safety *rule* would be that drivers on the highway may not exceed 55 miles-per-hour. The only issue for the court is whether a particular driver exceeded the speed limit. A traffic-safety *standard*, by contrast, might require that drivers always drive “reasonably” under the circumstances, leaving the court to determine *ex post* not only the speed at which the driver was traveling but also whether that speed was reasonable. Common sense would suggest that, for the driver trying to decide how to drive, the reasonable-driving standard would present significantly greater substantive legal uncertainty, and thus more of a motivation to purchase insurance, than would the relatively clear speed-limit rule.¹⁶

¹⁵ Kaplow. On rules/standards distinction in tax, cite Weisbach, Shaviro, and others. Of course, there can be both standards and rules governing the same activity, and that often is the case for activities – such as operating an automobile – that present special regulatory (for example, safety) concerns.

¹⁶ As we shall see, this example, though useful in capturing a basic distinction between rules and standards, fails to capture the complexity of the situation at least in the tax context, where the lawmaker may promulgate extensive, detailed rules, but the factual question of compliance can be extremely uncertain.

What does all this have to do with taxes? Is the federal income tax system the paradigmatic system of rules, or is it not? In fact, it is a *mixed* system, and although rules predominate in the U.S. system, standards are increasingly important.¹⁷ Moreover, with the most complex tax rules, even the question of factual compliance – the tax equivalent of whether a driver was going 55 or 56 miles per hour – can be difficult and costly to determine *ex ante*. Thus, on the one hand, the federal tax system probably has the most complex and comprehensive set of rules of any area of law. (At least that is what I tell my non-tax colleagues.) And despite frequent calls for radical simplification of the tax code, it probably makes sense that the tax system should have a lot of detailed rules. According to the orthodox legal theory of rules and standards, rules are generally to be preferred when the cost of determining *ex ante* what the permissible or required conduct should be for a given situation is relatively low (relative to an *ex post* determination, that is) and when the frequency of application of the rule is likely to be high. By contrast, standards are to be preferred when an *ex ante* determination of the optimal conduct is too costly and when the norm in question will be applied by the adjudicator relatively infrequently.¹⁸ This is why it could make sense in a tort system to have a general “reasonableness” standard regulating the conduct of, say, drivers,¹⁹ but it is difficult even to conceive of a tax system composed entirely of standards to be adjudicated *ex post*. Consider the silliness, for example, of a hypothetical tax system that had no precise rules but merely required all taxpayers to remit to the government each year a reasonable amount under the circumstances. The current compliance problems would pale by

¹⁷ Cite to greater use of standards in other countries, such as Canada and Australia.

¹⁸ Kaplow

¹⁹ It also makes sense, however, to have traffic rules, given that it is fairly easy to determine that driving over the speed limit (or, even more obviously, driving on the wrong side of the road) is almost always a bad idea.

comparison. In sum, any comprehensive tax regime will need to have detailed and at least somewhat (or relatively) complex rules.²⁰

Just as the tax system cannot rely solely on standards, however, neither can it rely solely on rules.²¹ The reasons for this conclusion are simple. First, neither Congress nor the Treasury Department can possibly anticipate all of the conceivable transactions that will be affected by the tax laws, nor would they want to. The Code is too long as it is, and, in any event, there comes a point at which the cost of ex ante rule-making, including the added complexity to the system, becomes too great. Second, and more importantly, whatever tax rules are adopted, no matter how specific or detailed or comprehensive, sophisticated taxpayers will always find opportunities for aggressive or abusive tax avoidance. The problem with such aggressive or abusive avoidance transactions, of course, is that they produce both distributive unfairness and inefficiency.²² The point here is that, if there were *no* background anti-avoidance standard to deter abusive avoidance, and if (implausibly) neither Congress nor the Treasury Department did *anything* to stop it, the harm to the tax system would be catastrophic. Any taxpayer able

²⁰ That is, we should expect the tax system to more relatively more rule-based than, say, the general tort system. This is not to deny, of course, that a plausible tax regime might rely substantially more on rules than the U.S. system does. Indeed, they may well be a good idea. It should also be noted that even a legal regime that seems to be primarily standards-based can develop into a more rule-like regime over time as, for example, when court decisions interpreting and applying the standard to various factual situations begin to accumulate.

²¹ Cite Weisbach's formalism article.

²² The distributive unfairness results because the ability to exploit the various tax loopholes is not evenly distributed across all taxpayers. Rather, loopholes tend to be concentrated in certain industries, or are available primarily to businesses organized in certain forms (C corporation or partnership, for example). In addition, the ability to exploit tax loopholes is limited primarily to those taxpayers with access to sophisticated tax advisors, a limitation that of course excludes most middle and lower income individuals. (In fact, many middle and lower income individuals employ tax-preparation firms to assist them with their taxes, but, as I discuss below, the economics of those relationships does not support aggressive tax planning.) The inefficiency, as opposed to the unfairness, of aggressive/abusive avoidance results as investment dollars flow to the industries and business forms with the most (or the most-effective) tax loopholes. There is also inefficiency associated with the administrative costs, including legal costs, incurred to design and implement these transactions. The result: too many bright young minds working as tax lawyers.

to come up with a clever loophole (or able to hire a tax expert to come up with one) could be confident *both* that it would be upheld by the courts *and* that Congress would do nothing to close the gap. The tax system would, if not collapse, at least become something very different from what it now is, as only the unsophisticated (or altruistic), would pay any income taxes at all. Of course, neither Congress nor Treasury would stand for that and would likely respond with new rules to close the loopholes. Thus, the real comparison is between a law-enforcement strategy of mixed rules and standards and one of purely rule-based responses. And the latter would be highly problematic. That is, when a new rule is adopted to close a newly discovered loophole, another round of tax-shelter “innovation” would ensue; Congress or Treasury would (eventually) respond to that; and the cycle would continue. The result would be an enormous and costly increase in the complexity of the tax laws.²³ By contrast, an anti-avoidance *standard*, applied *ex post* by the Service and by courts, also provides deterrence, by closing loopholes (retroactively), but it does so without producing nearly as much overall complexity as does the rule-based approach.²⁴ And again, this is because an anti-avoidance standard need not specify in advance every conceivable example of abusive avoidance that will be struck down; it need only state that transactions that fail to satisfy the standard (whether it

²³ Weisbach makes this point. Note that, if a rule-based response to tax loopholes included nominal retroactivity (which they almost never do), it would be comparable to standard-based response to aggressive tax avoidance, only Congress or Treasury as rule-makers – instead of courts or Service as auditors – would be applying the *ex post* standard. Logue, Legal Progress article. Under such a retroactive rule-based approach, then, it is not entirely clear that there would be an increase in complexity as compared with a standard applied by courts, since taxpayers would be deterred from looking for loopholes in the first place if they knew they would eventually be repealed retroactively. This sort of retroactive repeal, however, is very difficult to accomplish as a political matter. Moreover, at least as Congress is concerned, there may be public choice reasons why such loophole-closing legislation would be slow in coming, thus making reliance solely on a rule-based response aggressive avoidance impractical.

²⁴ In fact, the use of a standards based approach to tax law, if accompanied by the purchase of tax insurance, would not necessarily reduce overall complexity, though it might. The question is whether insurers, in underwriting their policies, would simply replace the complexity of detailed tax rules with the complexity of detailed insurance policies. More on this in Part ___ below.

be economic substance or business purpose or something else) will be disallowed, in which case the taxpayer will owe back taxes plus interest and – if the interpretation of the Code was too aggressive – penalties as well.

The Problem of Legal Uncertainty

With the use of legal standards, however, comes a degree of substantive legal uncertainty. Back to the traffic-safety example: Will my driving, in the event I am stopped by the police or should an accident occur, be deemed to have been reasonable under the circumstances? Indeed, this is just the sort of legal uncertainty that can motivate the purchase of liability insurance, including auto-liability insurance. A similar story can be told with respect to standards in the tax laws. Because a tax anti-avoidance standard leaves open the precise definition of what constitutes impermissible tax avoidance, taxpayers engaged in tax planning must face a degree of legal uncertainty, that is, uncertainty as to what the law is and how it will be applied to a given factual situation. At least in the tax context, however, it is not only the anti-avoidance standards that can produce legal uncertainty; so can highly complex rules, whose factual application to a given transaction can be difficult to sort out in a timely fashion. Either way, substantive legal uncertainty, of course, is not *per se* a good thing.²⁵ It may well produce non-optimal incentives. Thus, uncertainty in the application of a legal standard (or a highly complex set of rules) can actually induce over-compliance with the laws in question. In the torts context, for example, an uncertain standard – such as the negligence standard – can, under certain assumptions, produce over-investment in accident avoidance, that is,

²⁵ Thus, Weisbach notes that there is a tradeoff between the uncertainty of a standards approach and the complexity of a rules approach.

excessive care rather than due care.²⁶ Likewise, an uncertain anti-tax-avoidance standard can lead to over-compliance under certain conditions. A taxpayer facing uncertainty as to how the IRS or a court will apply the economic substance or business purpose standard to the taxpayer's particular transaction might decide to over-comply with the law by, for example, building into the transaction an excessive amount of non-tax business risk, just to ensure compliance with the standards and thus avoid underpayment penalties, even though such additional risk is pure economic waste.²⁷ Alternatively over-compliance in the tax context might take the form of overpaying taxes. For example, imagine a corporate taxpayer that has engaged in a particular transaction entirely for non-tax reasons, a transaction that happens to be arguably (though not clearly) entitled to special tax treatment. Facing the prospect of an uncertain anti-avoidance standard, however, that taxpayer may decide to forego reporting the transaction in the favorable way (even if the Congress would have intended it to do so) solely out of fear of an ex post determination by a court that the characterization was improper. Or at the margin, a taxpayer may decide not to undertake a socially desirable transaction because of doubts about whether the tax treatment essential to the profitability of the deal will be upheld.²⁸ Any or all of these forms of over-compliance could arise, interestingly, even if we assume that

²⁶ Calfee and Craswell. It can also be shown that uncertain legal standards produce under-compliance in some circumstances; however, under plausible assumptions, the over-compliance problem tends to be more likely and significant.

²⁷ This type of over-compliance can arise even if we assume (and even if taxpayers assume) that the court will get the ex post analysis correct. The uncertainty arises because neither the taxpayer nor Congress nor anyone else can predict ex ante what the appropriate treatment of the transaction should be.

²⁸ Here I have in mind a transaction that exploits either a tax-expenditure provision or a structural element of the Code in a way that only the IRS or a court ex post can determine for certain is permissible. That is, with this sort of transaction, although an argument can be made the Congress intended for a tax subsidy of some sort to apply, the final determination can only be made after the fact. By assumption, then, if taxpayers, due for example to risk aversion, opt not to engage in such transactions, it is a type of social waste. According to proponents of tax indemnity insurance, this sort of inefficient "chilling effect" of uncertain tax standards has motivated the demand for insurance. See *infra* Part IV.

taxpayers are risk neutral.²⁹ If we introduce the possibility of risk aversion on the part of sophisticated taxpayers, and even corporate taxpayers (specifically, corporate managers), the over-compliance problem would be even greater. Moreover, if taxpayers are risk averse, there is also the social cost associated with their bearing this risk, in addition to the cost of over-compliance.³⁰

In sum, we can think of the tax compliance/noncompliance distinction as a continuum, with criminal evasion on one end and clear compliance on the other. The difficulty for tax law-enforcers is policing the middle ground, where the taxing authorities have to distinguish permissible interpretations of the Code from impermissible ones. And it is not always easy. Indeed, because of the nature of the tax laws (the nature of language, really), it is important for the tax system to have some background anti-avoidance standards to prevent taxpayers from exploiting inevitable loopholes in the Code. The existence of such standards, however, introduces legal uncertainty, which can produce non-optimal tax-avoidance incentives as well as inefficient risk bearing, although the lack of such standards, from a tax enforcement perspective, would lead to either gross unfairness or inefficiencies in the application of the tax laws or to an impossible degree of complexity in the Code as Congress would have to respond legislatively to each new loophole. Moreover, even highly complex rules can produce legal uncertainty, if it is difficult *ex ante* to determine how they will be applied *ex post* to a given set of facts.

²⁹ As Calfee and Craswell demonstrate, the tendency to over-comply in situations involving uncertain legal standards is the result, not of risk aversion, but of the discontinuity within the standard, whereby a finding of compliance exempts that regulated party from all of the costs of its behavior.

³⁰ Below I discuss whether and why corporate taxpayers might be, or behave as if they are, risk averse.

One potential solution to the tradeoff we now face – between the deterrence advantages of an anti-avoidance standard and the increased legal uncertainty such a standard presents – would be tax indemnity insurance (or tax uncertainty insurance), which is now being sold by commercial insurance companies. Indeed, as mentioned above, one of the primary justifications offered by tax-insurance promoters and lobbyists is the claim that tax indemnity policies are serving the function of shifting legal uncertainty from taxpayers to insurance companies and thereby facilitating socially desirable, wealth-creating transactions – that is, by reducing various forms of over-compliance. Moreover, these proponents of tax insurance argue that such insurance provides a useful and in some ways more efficient substitute for the IRS’s private letter rulings, which, in effect, amount to a form of free government-provided legal uncertainty insurance. Before we get to the merits of these arguments, however, let us review some of the facts (such as they are) about the existing market in tax insurance. First, I will take a brief detour, by way of background, into what I call the old market in tax insurance, which still exists (and thrives) today, and then I will describe the new market, which is much smaller in scope point but is in some ways more interesting.

II. The Old Market in Tax Insurance: Tax-Preparer (and Tax-Advisor)

Warranties

The Content of Tax-Preparer Warranties

Long before there was anything resembling tax indemnity insurance policies, there was a type of tax insurance, which still exists today and is sold to millions of individual taxpayers: These are the warranties provided by tax-return preparers for their

clients.³¹ Although the content of these warranties varies from one tax preparer to another, there is, based on my research, a considerable degree of overlap.³² The typical preparer warranty provides that if the preparer commits an error in preparing the taxpayer's return and that error results in the IRS's assessing interest and penalty charges against the taxpayer, the preparer will cover those additional costs. Most preparers further narrow the standard coverage by specifying that the coverage is triggered only by "calculation errors" on the preparer's part; some preparers, however, are less specific about what precisely will trigger coverage.

In any event, the standard tax-preparer warranty typically limits coverage to preparer "errors" of one kind or another and thus leaves taxpayers themselves responsible for any interest or penalties caused by their own mistakes or malfeasance. For example, if a taxpayer fails to tell the tax-preparer of some item of gross income that she received in a given year and the preparer leaves that item off the taxpayer's return, or if the taxpayer simply provides incorrect numbers with respect to some item of income or deduction, any resulting penalties and interest would be the responsibility of the taxpayer. This standard warranty is provided by most tax-preparation firms and most tax-preparation software companies, including TurboTax; and the price for this coverage is typically included in the basic cost of the service.

³¹ In terms of state insurance law, the regulatory definition of the term "insurance" does not typically encompass service- or product-warranties. This means that those companies issuing warranties need not qualify as insurance companies or meet all of the requirements (including solvency requirements) imposed on such companies by state law. I have found one instance, however, in which a state insurance regulator treated a particular tax-preparer warranty as "insurance" for state insurance regulatory purposes. [cite and discuss]

³² I have not done a comprehensive survey of the content of these warranties across the industry. Rather, I have focused on the warranties provided by H&R Block and Jackson Hewitt, which together handle roughly 16 percent of all individual federal income tax returns filed with the IRS. In addition, I have spoken with several accountants at other firms as well as with others familiar with the accounting industry.

Conspicuously absent from the *standard* tax-preparer warranty is coverage for underpaid taxes. That is, they cover penalties and interest, but not the underpaid taxes themselves. This is not to say that tax-underpayment warranties are never offered. They sometimes are. But they are generally offered separately, as a “rider” to the basic warranty.³³ Although tax deficiency coverage is offered by some preparers, however, I would not be surprised taxpayers rarely opted to buy it.³⁴ It is not that tax deficiencies can never be large and unpredictable enough to motivate a demand for insurance. Indeed, as I will discuss in the next Part, it is the risk of an unexpected (and large) tax deficiency, rather than the risk of penalties, that seems to generate most of the recent demand for tax indemnity insurance. The difference between the tax indemnity insurance market and the market for tax-preparation warranties, however, is the magnitude of the risk. For most individual taxpayers who are having a return preparer do their returns, as compared with the corporate taxpayers who are purchasing tax indemnity policies, the amount of the potential tax deficiency is relatively small, not only in absolute terms but relative to the overall tax liability.³⁵ A big reason for this, which I will return to shortly, is that most individual taxpayers – and certainly the ones who have hired tax-return preparers to file their returns – are not likely to be engaged in some sort of aggressive shelter transaction, which by definition puts substantial tax dollars at risk. Rather, they have decided to use a

³³ Both H&R Block and Jackson Hewitt, for example, offer special “extended” warranties that, for an additional fee, provide coverage for underpaid taxes. In both cases, however, the amount of coverage for underpaid taxes is capped – \$5000 for H&R Block, and \$6000 for Jackson Hewitt. And in both cases, coverage is triggered by the preparer’s error. Thus, combining both the standard and the extended warranties, if an H&R Block or Jackson Hewitt tax-return preparer makes an error on a return (either a computational error or an error in interpreting the law), and the IRS catches this mistake and issues a deficiency notice to the taxpayer requiring additional taxes plus interest and penalties, the company will pay all of the penalties and interest, as under the standard warranty, *plus* up to the policy limits (\$5000 or \$6000) in back taxes.

³⁴ I have thus far not been able to determine what percentage of H&R Block or Jackson Hewitt customers purchase this extended warranty nor, for that matter, how many tax-return preparers provide such extended warranties.

³⁵ Look for data on this in empirical literature on compliance and use of preparers.

preparer (or tax-preparation software) simply because they find the tax laws to be too complex to manage on their own. They do not typically go to return preparers (and certainly not to such firms as H&R Block or Jackson Hewitt) for tax shelter advice.³⁶ Moreover, if I am wrong about the size of the potential tax-deficiency risk faced by most individual taxpayers in filing their returns, that would suggest another reason why return preparation firms would be reluctant to provide coverage against tax deficiencies: that is, if the risks are large, tax-preparation firms may simply not be willing to take on the extra risk. Thus, just as most product manufacturers would prefer not to become “insurers” for the consequential harms associated with their products, and thus typically attempt to disclaim such warranties, it is possible that many tax-return preparers simply do not wish to become the insurers of their customers’ overall tax liability. In addition, even if the firms were willing to take on the additional risk, they may not wish to take on the extra regulatory burdens (including licensure and solvency requirements) associated with being “engaged in the business of insurance” for state regulatory purposes. And that outcome may more likely if the return preparer were to sell tax-deficiency coverage in addition to the basic warranties.³⁷

Interestingly, H&R Block also provides coverage for tax underpayments caused not only by their errors but also by *a change in IRS’s interpretation of the law*. What counts as a qualifying change in interpretation is not entirely clear, and I have not been able to find other examples of this sort of coverage being provided by a tax-preparation firm, although, again, my research on the issue has not been comprehensive. My best

³⁶ This conclusion, which is my own educated guess, does not mean that the use of return preparers overall necessary enhances the accuracy of tax filings. See discussion in text below.

³⁷ Indeed, at least one state (New York), has issued an official determination that the “extended” or “extra” warranty for tax underpayments offered by H&R Block amounts to “insurance” for state regulatory purposes. Attorney General of New York, Informal Opinion, March 28, 2000.

guess is that other, smaller tax-preparation firms may do this as well, at least for their preferred customers. As for the H&R Block warranties, presumably if the taxpayer were to take a position on a return prepared by H&R Block in reliance on the IRS's clearly stated interpretation of a given tax rule (perhaps an interpretation stated in a revenue ruling or some other official pronouncement of the Service), and then after the return was filed the Service were to change its interpretation and this new interpretation were applied to the taxpayer causing additional tax liability, this special warranty language would be triggered. Such a contingency, however, seems highly unlikely for most taxpayers, although perhaps not impossible. Perhaps the unlikelihood of the contingency explains the lack of demand for it by taxpayers and hence its rarity. However, As I have already suggested in the previous Part (and as I discuss below in greater detail), this particular type of risk – that is, the uncertainty with respect to how the IRS will interpret the tax laws – plays a dominant role in the new market for tax insurance.

A final observation about tax-preparer warranties is that they also typically include a modest commitment to assist the taxpayer in the event of an audit. This guarantee entails a promise to help the taxpayer, in the even of an audit, answer basic questions regarding how her return was prepared and how the various numbers were calculated. The guarantee, however, specifically declines to promise full-fledged legal representation; to the contrary, it expressly disclaims that obligation. Interestingly, tax preparers also sometimes guarantee that if the taxpayer *overpays* her taxes and does so as a result of the preparer's error (typically, only if it is a calculation error), the preparer will assist in filing an amended return to recover the excess taxes paid and will reimburse the taxpayer for any interest on that amount. Thus, tax insurance against errors on the part of

tax preparers, which again has been in existence for some time, can be symmetrical, covering calculation errors in both directions.

Assessing Tax-Preparer Warranties

The foregoing is a rough picture of the old market in tax insurance, which is probably better described as a market for tax-preparation warranties. In their current form, they have certain characteristics that are common to other service- and product-warranties, characteristics that suggest the contracts are probably social-welfare-enhancing, although they may, under certain conditions, present consumer-protection. That is, if the consumers who purchase the warranties are asymmetrically uninformed or systematically misperceive the risks being insured, there may be a need for government regulation. The case for such intervention would be no different from the same sorts of arguments that get made about consumer product warranties, and this sort of regulation is typically done at the state level either by state attorneys' general (enforcing state consumer protection laws) or by state insurance regulators (if the warranties happen to qualify as insurance.)³⁸ The more pertinent question for the purposes of this Article is whether tax-preparation warranties – at least the ones comparable to those offered by the large tax-preparation firms – present any *tax-law-enforcement* or compliance concerns. The answer seems to be that, although the use of tax preparers may have some negative effects on taxpayer compliance (as well as some positive effects), there is no obvious compliance cost (or benefit) associated with the warranties per se. That is, the existence of these warranties probably does not, by itself, create an incentive for insured taxpayers to take overly aggressive positions on their tax returns.

³⁸ There may be reasons in fact to worry about tax-preparer services generally on consumer-protection grounds. [cite to Texas case involving class actions suits filed against H&R Block alleging fraud in marketing and financing of certain tax-refund loans to their customers.]

Whether an individual taxpayer's use of expert assistance in preparing a tax return leads to increased or reduced compliance is a question that has been studied by economists. Within that literature, one of the more interesting hypotheses is that tax-return preparers, and perhaps tax-advisers more generally, (a) tend to increase compliance with complex but clear legal rules but (b) tend to reduce compliance (or increase noncompliance) with rules that are more ambiguous or uncertain. Put differently, tax preparers are "rule enforcers" and "ambiguity exploiters."³⁹ The idea is this: With respect to clear but complex rules, individual (presumably unsophisticated) taxpayers may inadvertently fail to comply simply from lack of understanding; whereas hired tax experts, who are able to decipher these complex rules, will tend to correct these errors, producing greater overall compliance with such provisions. The assumptions here are (a) that return preparers are better able to understand such complex provisions than can the taxpayers who hire them, which makes obvious sense, and (b) that, although the rules are complex they are clear, and thus tax experts have an incentive to counsel in favor of compliance. This latter assumption would hold because "noncompliance" in this context would in effect amount to "evasion," which would subject not only the taxpayer but the preparer to near certain, and potentially severe, penalties in the event of audit. By contrast, where the legal requirements are more ambiguous (or, to use the language from the previous Part, more "standard-like"), the effect may be the reverse. This would be true if taxpayers tend react to ambiguity by risk-aversely by over-complying (for example, by not taking deductions that they are not sure they are entitled to), whereas tax preparers react to the same ambiguity more aggressively. There is at least some evidence to suggest that these conditions do hold in some settings, and that the rule-

³⁹ Klepper & Nagin (1989, 1991); others.

enforcer/ambiguity-exploiter hypothesis may have some real world validity, although the evidence is not beyond dispute (and the policy implications are not clear).⁴⁰

In any event, whatever the outcome of that debate, it does not bear directly on the question of warranties or insurance. That is, whether or not paid preparers on balance have good, bad, or no effect on taxpayer compliance overall, that preparers tend to provide warranties for their work would not, by itself, seem to present a large tax-compliance problem, at least not yet. The one way in which they might present a problem would be if the promise of tax-penalty insurance/warranties induced taxpayers to take more aggressive positions or to allow their return preparer to take more aggressive positions on their behalf. And this is certainly possible. Just as aggressive tax planning can be in the narrow self interest of both sophisticated taxpayers and their advisors, it can also be in the self interest of average individual taxpayers and their return preparers to be aggressive; and the use of warranties could conceivably encourage this sort of behavior. However, it is unlikely that this would be, or become, a significant tax-compliance problem for middle or lower-income taxpayers who use the large return-preparation firms. These are not taxpayers with the resources or incentives to engage in complex quasi-legal tax-shelter transactions of the sort that would appeal to wealthy or corporate taxpayers who (a) have more absolute tax dollars and a higher percentage of their income at stake in the tax avoidance game and (b) can hire expensive tax lawyers and accountants to help them with their tax planning. Moreover, given the nature of the wholesale tax-preparation business, tax-return preparation firms are simply not in a position to provide this sort of complicated tax-shelter planning advice.

⁴⁰ Cites. Slemrod's recent tax compliance volume.

In sum, a case can be made that tax-preparer warranties efficiently allocate the risk of tax-preparer mistake to the one who is the obvious cheapest-cost-avoider and best insurer: the tax-preparer. Moreover, at least with respect to the large wholesale tax-preparation firms, there seems to be relatively little tax-compliance problem associated with the use of warranties, although whether the use of tax return preparers itself increases or decreases compliance is an open question.

What about Tax-Advisor Warranties (also called Contingent Fees)?

Tax-return preparers are not the only tax professionals providing implicit or explicit service warranties, or so I am told. That is to say, some tax advisors who provide taxpayers with expert opinions as to the appropriate or likely tax treatment of particular transactions, but who are not tax-return preparers per se, also provide a type of warranty to their clients.⁴¹ These warranties have some things in common with return-preparation warranties and some things in common with tax transaction risk insurance. Like tax transaction risk insurance, these warranties apply to specific opinions offered by the advisor with respect to particular tax issues; they do not, in other words, apply to the taxpayer's entire tax return. (Tax preparer warranties apply to the entire return, as preparation of the entire return is the service being warranted.) Like tax preparer warranties, however, tax advisor warranties offer less than full indemnity for losses. That is, unlike tax indemnity insurance policies, tax advisor warranties do not cover taxpayers against the possibility of penalties, interest, or tax deficiencies themselves, but rather take

⁴¹ By "tax advisor" here I mean someone who advises a taxpayer regarding how to report a given transaction on the taxpayer's return. The advisor therefore is being consulted for expertise on the tax law as it applies to a particular situation. By "tax return preparer" I mean someone who fills out the tax return itself. Obviously, the preparer may give advice on certain issues as well; thus, the distinction does not always hold up. But one can still usefully distinguish between the H&R Blocks of the world and the lawyers and accountants that give more specialized advice on specific issues – usually to corporate or wealthy individual taxpayers.

the form of a money-back guarantee: If the particular issue on which the advisor gave an opinion ends up being challenged on audit and rejected by the IRS (and by a court), the advisor agrees to refund some or all of the fees that were charged for the advice. Such an arrangement can be an explicit element of the service contract between the advisor and the taxpayer, or it can be explicit. It is my understanding that such arrangements are common.⁴²

What is interesting is that these warranties are, in effect, contingent-fee arrangements, and such arrangements are frowned upon (and in some cases forbidden) by the Treasury Department. For example, the recently revised Circular 230 specifically prohibits those admitted to practice before the IRS from using contingent fee arrangements, except in circumstances in which the advisor is giving advice with respect to an amended return.⁴³ Relatedly, the Treasury Regulations that define the category of tax transactions that must be flagged by taxpayers as so-called “reportable transactions” include transactions that have “contractual protection,” which amounts to tax transactions

⁴² As far as I am aware, there is no published data on the prevalence of these arrangements. However, I have been told by some tax lawyers that it is common. This assessment is consistent with public comments that were made in connection with the original proposed 6011 regs, discussed below.

⁴³ In those regulations, a contingent fee is defined as follows:

[A] contingent fee is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

Circular 230, sec. 10.27, revised 7-2002. Circular 230 then provides that “[a] practitioner may not charge a contingent fee for preparing an original tax return or for any advice rendered in connection with a position taken or to be taken on an original tax return.” However, “[a] contingent fee may be charged for preparation of or advice in connection with an amended tax return or a claim for refund (other than a claim for refund made on an original tax return), but only if the practitioner reasonably anticipates at the time the fee arrangement is entered into that the amended tax return or refund claim will receive substantive review by the Internal Revenue Service.” Id.

involving contingent-fee arrangements.⁴⁴ It is not entirely clear how these two sets of regulations are supposed to work together. It seems, however, as if a tax advisor who wants to maintain her ability to practice before the IRS may not charge a contingency fee (or structure her fee to provide contractual protection) on a reportable transaction *even if the transaction is reported by the taxpayer* if the transactions does not involve a claim for a refund. If, however, the transaction does involve a claim for a refund, not only is a contingent arrangement allowed, but there is an exception to the reporting requirement for the taxpayer as well.⁴⁵ In any event, the Treasury Department seems to be deeply concerned about contingent-fee arrangements between tax advisors and taxpayers, but not the least concerned about tax-preparer warranties that promise, not reimbursement of fees, but coverage of back taxes, penalties, and interest.⁴⁶ And this probably makes some sense, because of differences in the two markets mentioned above: tax preparers are dealing with relatively simple returns for individuals and are less likely to be involve in

⁴⁴ Treas. Reg. 1.6011-4 requires taxpayers to report transactions that involve “contractual protection,” which is defined as follows:

A transaction with contractual protection is a transaction for which the taxpayer or a related party ... has the right to a full or partial refund of fees (as described in paragraph (b)(4)(ii) of this section) if all or part of the intended tax consequences from the transaction are not sustained. A transaction with contractual protection also is a transaction for which fees (as described in paragraph (b)(4)(ii) of this section) are contingent on the taxpayer's realization of tax benefits from the transaction. All the facts and circumstances relating to the transaction will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to the transaction have not designated as fees or any agreement to provide services without reasonable compensation.

1.6011-4(b)(4)(i).

⁴⁵

If a person makes or provides a statement to a taxpayer as to the potential tax consequences that may result from a transaction only after the taxpayer has entered into the transaction and reported the consequences of the transaction on a filed tax return, and the person has not previously received fees from the taxpayer relating to the transaction, then any refundable or contingent fees are not taken into account in determining whether the transaction has contractual protection. This paragraph (b)(4)(iii)(B) does not provide any substantive rules regarding when a person may charge refundable or contingent fees with respect to a transaction.” 1.6011-4(b)(4)(iii)(B).

⁴⁶ As far as I can tell, neither Circular 230 nor any other regs address tax-preparer warranties of this sort.

very aggressive shelter-type activity, whereas some tax advisors are. The concern with these regulations, however, is that they are over-inclusive and require reporting, or effectively forbid contingent fees, in circumstances in which there is no special concern about aggressive avoidance. I will return to this issue below, after I have outlined the nature of and problems with the tax indemnity insurance market.

III. The New Market In Tax insurance: Tax Transaction Insurance

As already mentioned, over the past few years insurance companies have begun to sell a new type of tax insurance. Tax indemnity or tax transaction insurance policies are different from the traditional tax-preparer warranties in several key respects. First and most obviously, tax insurance policies are not warranties issued by tax preparers. They are actual insurance policies issued by actual insurance companies. Thus, when a tax insurance policy is purchased, certain tax risks are transferred to the insurance company, which then pools and distributes the risks and sometimes reinsures them with other insurance companies. That tax indemnity policies are regulated as “insurance” by state agencies may also have consequences for the enforceability of the contracts in some situations. A second general difference between tax transaction insurance and preparer warranties is that the former are not mass-marketed in standardized forms to individuals for relatively small risks. Rather, tax transaction insurance is a type of custom-designed insurance, and it is sold exclusively to wealthy and commercially sophisticated (typically corporate) taxpayers that are seeking to cover large (sometimes extremely large) tax-related risks – potential liabilities in the millions, tens of millions, and even hundreds of millions of dollars. That the policies are individually negotiated in this way may have

consequences for how courts will interpret the language of the contracts. Finally, as already mentioned, and as discussed further below, these policies are written on a transaction-specific basis: they cover the tax treatment of particular tax transactions, not of entire tax returns.

The Content of the Policies

Because they are not standard-form contracts, it is difficult to describe the “typical” tax transaction policy. Nevertheless, based on the evidence I have seen, there are enough important features in common that some generally applicable descriptive comments are possible.⁴⁷ Tax insurance policies cover the risk that the IRS will rule unfavorably with respect to some tax position that the taxpayer has taken or plans to take on its tax return. The coverage typically includes the amount of the tax deficiency as well as for any interest and penalties that are assessed up to the limits of the policy. These policy limits can, again, be in the hundreds of millions of dollars, although limits in the tens of millions are more common. The policies typically provide full “gross ups,” which means that insofar as the insurance payouts themselves are considered income for tax purposes, the insurer will cover that additional tax as well, and the resulting additional tax liability, and so on, “grossing up” the overall payment until the taxpayer is made whole on an after-tax basis. In this way the insurance aims to leave the taxpayer whole with respect to the risk of a negative tax ruling, with one exception: As do virtually all

⁴⁷ My knowledge of the tax indemnity insurance market and the content of the policies themselves derives from a number of conversations with individuals in the insurance industry who are involved in the design and marketing of these policies as well as with a number of tax lawyers who either have been hired to provide legal opinions to tax indemnity insurers or have advised their clients regarding the purchase of such insurance. In addition, I have read a number of sample policies that were sent to me by insurers or by insurance brokers or that I downloaded directly from insurance-company websites. In addition, there is one published source of background information on the market for TIIPS. See generally Richard A. Wolfe, Tax Indemnity Insurance: A Valuable and Evolving Tool for Managing Tax Risks, 598 PLI/Tax 595 (Oct.-Nov. 2003).

commercial liability insurance policies, tax indemnity policies include a substantial deductible, which is intended to help reduce moral hazard concerns.

As with standard commercial liability policies, tax transaction policies provide coverage for the legal and accounting costs of contesting the liability, although the language here is different from a standard commercial liability policy. For example, although the policies clearly provide for coverage of some of the legal costs of defending the tax position against government challenge (sometimes called “contest expenses”), they also state clearly that “the insurer has no duty to defend” the insured, which duty is a standard part of most liability insurance policies.⁴⁸ Tax transaction policies are written exclusively on a claims-made basis; that is, they cover only losses for which claims are made during the policy term, which is typically three years (or the length of standard statute of limitations for the Service to issue a “notice of proposed adjustment”). The policies also contain provisions requiring the insured-taxpayer to notify the insurer in the event of a claim and to cooperate with the insurer in the event of an insured loss, all standard terms in liability policies.

Tax transaction insurance policies are almost always sold on a transaction-specific basis – that is, to cover the tax risk associated with a single transaction. Thus, such insurance is rarely sold to cover a corporate taxpayer’s entire tax return and all of the tax risks contained therein. (This is another difference between tax indemnity insurance and tax-preparer warranties, which, though much more modest in the amount of coverage, do

⁴⁸ It is not entirely clear what the difference is between assuming a duty to defend (which is what liability policies typically do but tax insurance policies do not) and agreeing only to cover “contest expenses.” This distinction may be an effort by insurers in drafting the policies to avoid state common law responsibilities that attach to the duty to defend. Relatedly, tax insurance policies typically give the insured-taxpayer the right to choose the lawyer to contest the IRS determination and to direct the case, but they impose a generally worded obligation on the insured-taxpayer to conduct the case as if there were no insurance in place, and they require consultation with the insurer on settlement negotiations.

apply to the entire return.) Most commercial liability insurance, by contrast, covers the insured for a wide range of risks for given period of coverage. The rationale for the transaction-specific structure of tax insurance seems clear: to provide the insurer a way of limiting its exposure to particular tax positions that it – and its tax law experts – have been able to examine, assess, and ultimately price.⁴⁹

The Benefits of Tax Indemnity Insurance

Before we address the potential hazards of tax indemnity insurance, consider the benefits. As mentioned in Part ___ above, because of the uncertainty inherent in the tax laws (as a result both of vague anti-avoidance standards and highly complex systems of rules), there can be an incentive for taxpayers to over-comply, for example, by overpaying taxes or by not engaging in certain socially beneficial transactions for fear of incurring an unexpected and large tax deficiency as well as penalties. As discussed in Part ___, this problem can arise even if taxpayers are not risk averse; however, the problem is especially acute if taxpayers are indeed risk averse. In theory, then, if we assume that taxpayers are risk averse generally with respect to the possibility of large tax deficiencies, penalties, and interest, the purchase of tax indemnity insurance could conceivably reduce the problem of over-compliance with the tax laws, resulting in improved efficiency as well as distributional fairness.⁵⁰ The idea is that, once the risk of a substantial tax deficiency and penalties are shifted from the taxpayer to the insurer, the

⁴⁹ The closest analogy to this sort of transaction-specific insurance outside of the tax context would be first-party property insurance that is sold on a property-by-property basis.

⁵⁰ Some tax commentators may regard “over-compliance” of this sort a good thing, because they have a problem with the underlying tax law. For example, if you think the non-taxation of 355 spinoffs of subsidiary corporations or the nontaxation of 368 reorgs are a bad thing – i.e., that such transactions should give rise to recognition of gain – then it would be, on this view, desirable if uncertainty in the tax laws lead to over-compliance in the form of taxpayers not engaging in such transactions. The only response I have to that position is this: If we believe that the underlying tax law is undesirable, it would be better to repeal or amend the law rather than allow the law to be uncertain.

taxpayer would have nothing to gain by over-compliance.⁵¹ Moreover, insofar as risk aversion on the part of taxpayers is the underlying motivation for the purchase of the tax insurance, the presence of such coverage would improve overall social welfare simply by reducing the societal costs of risk-bearing. That is, simply shifting the risk from the relatively risk-averse taxpayer to the relatively risk neutral insurer itself produces a social-welfare gain.

Given the importance of risk aversion to this story, an interesting question is why we should assume that sophisticated taxpayers – here, primarily, corporate taxpayers – are risk averse. While it is undeniable that corporations and businesses organized in non-corporate forms often purchase insurance policies, including liability insurance policies of various types, it is not clear, as a matter of theory, why they do so. Whereas a risk-averse individual is by definition an individual who would prefer to pay a certain dollar amount rather than bear an uncertain prospect of the same expected value. In other words, those who are risk-averse are willing to pay at least an actuarially fair premium to shift a risk of loss to an insurer, and most individuals are thought to be risk averse at least with respect to risks that involve small probabilities and large potential losses.⁵² The demand for insurance by corporations is a bit more difficult to explain. With respect to a closely held corporation, which one might assume would involve owners who have some preference for risk, the explanation is not so difficult: The owners of the corporation may be risk preferring with respect to certain types of business risks (after all, they are

⁵¹ The concern, of course, is that the presence of insurance will also eliminate the benefit of any compliance. This is the moral hazard concern that confronts all insurance transactions, and I will return to this issue below.

⁵² In one of the all-time great examples of circular reasoning, the assumption that individuals are risk averse derives largely from the observation that individuals behave as if risk averse – such as by purchasing insurance.

entrepreneurs), but averse with respect to other types of risk. This sort of duality of risk preferences is common and need not be understood as irrationality. (Think of all the individuals who buy both lottery tickets as well as insurance policies.) Thus, even entrepreneurs or gamblers may want to limit the types and amounts of risk they take on, and insurance is one way to do this. For closely held corporations and for partnerships, then, the standard story of risk-aversion would apply without much trouble.

The practice that is somewhat more difficult to explain is the purchase of insurance by large, publicly traded corporations. (And indeed, many of the tax indemnity insurance policies are being sold to publicly traded corporations.)⁵³ In theory, most if not all of the shareholders of public corporations are diversified; therefore, such corporations, should behave as if they are risk neutral, assuming their managers are reliable agents of the shareholders. Of course, even if corporate shareholders are risk neutral, corporate managers may be risk averse with respect to certain types of catastrophic (potentially bankrupting) liabilities, because managers have undiversifiable human capital at risk in the company. Or even if the potential liabilities do not threaten to bankrupt the company, they may be considered career-ending events for corporate managers, the prospect of which would certainly be enough to make corporate managers risk averse with respect to such liabilities. Indeed, this characterization may describe many corporate tax managers, for whom the rejection by the IRS and the courts of a major tax transaction (especially if penalties are assessed) is often said to be a career-ending, or certainly career-limiting, event for the in-house tax manager, and perhaps for official higher up the food chain, at a large corporation. Thus, the purchase of tax insurance (or liability insurance more generally) by the corporation in such a case can be viewed either as a straight agency-cost

⁵³ cites

problem or, more optimistically, as a legitimate, if indirect, means of compensating risk-averse managers.

There is an alternative explanation of corporate insurance, including corporate tax insurance, that also involve a risk-aversion story of sorts but that is more complex than the story just described. If we take at face value the way in which corporate managers often explain their purchase of insurance, and how insurance brokers who market insurance policies to corporate risk managers describe the benefit of the policies, the best explanations for the purchase of insurance – including tax indemnity insurance – by public corporations may depend on the assumption that there is some level of risk aversion or perhaps irrationality among investors, not managers. A simplified version of this story goes as follows: Management is worried that, if there is a large unforeseen liability in a particular year (whether it is a tort judgment or a tax deficiency), it will cause a “shock” to – or a surprise downward movement in – reported earnings, which in turn will cause investors to overreact, leading to a drop in share price. And a drop in share price, even if temporary, can have consequences for the company by raising the cost of capital.⁵⁴ Roughly the same thing happens if the corporation discovers a “potential liability” and books a reserve for it on its financial statements. Such a reserve, if large, can have a similar effect on share prices and in turn the cost of capital. Insurance thus provides a means of smoothing earnings over time. That is, instead of waiting for the loss to occur and paying it then, and instead of booking a reserve in anticipation of the loss’s happening, the corporation can simply pay a premium to shift the risk to an insurer, who pays the loss if and when it occurs. The insurance transaction, in other words,

⁵⁴ It can also have consequences for management compensation, which might produce a sort of risk aversion among managers.

removes the liability from the insured-corporation's balance sheet. If the corporation renews the insurance every year, these annual insurance transactions have the effect of spreading the cost of such liabilities over a number of years – thus avoiding the problem of earnings shocks.

Versions of this story are often used to justify the purchase of tax indemnity insurance policies. Indeed, some corporations have purchased tax indemnity policies for explicitly this reason: to protect a position they have taken on their tax return which, if overturned by the IRS, would have an untoward effect on corporate earnings. Likewise, some companies have purchased tax indemnity policies to cover a given tax-related transaction not because of the direct effect on their own share price, but because their companies are seeking to merge with other companies, and the deals will not go through without the tax insurance coverage. (Insofar as the acquirer is a closely held corporation, of course, the straightforward risk-aversion story would apply.) In another example, a private corporation purchased tax indemnity coverage to insure the tax benefits of a particular transaction, because it determined that doing so would increase the value of its initial public stock offering. Put more generally, in any number of corporate contexts, it has been argued that a particular type of corporate transaction will be killed or at least made significantly more expensive if there is perceived to be a large, unfunded (i.e., uninsured) tax contingency hanging out there. Tax indemnity insurance, the argument goes, can provide a response to all of these concerns.

Of course, the basic question remains: Why would presumably diversified investors care about such tax-law uncertainty unless they are risk (or uncertainty) averse? Are they not fully diversified and thus indifferent with respect to such risks? I still do not

have a fully satisfactory answer to this question. Here is the best I can do for now: The corporate demand for insurance, including the demand for tax-indemnity insurance, at least among the largest corporations, seems to be the result of either (a) some residual risk aversion on the part of the relevant investors (whether it is the taxpayer's shareholders or the shareholders of the merging corporation or the shareholders of the lending organization), (b) some irrationally on the part of those investors with respect to surprise earnings adjustments, or (c) some non-obvious signaling explanation (for example, investors take the earnings shocks to be a signal of some underlying larger problem of which they had not previously been aware). Or maybe some combination of the three. Moreover, it still remains possible that the insured-taxpayers in these transactions, through the purchase of tax-indemnity insurance, believe they are able to get access to credible and bonded expert tax advice that may not be available on the normal legal market.

The Curious Example of Retroactive Tax Insurance

There is one type of tax indemnity insurance that requires additional explanation. Some tax-indemnity policies are being purchased by taxpayers who have already received notice that the IRS is challenging an issue on their return. That is, some taxpayers who have received a "notice of proposed adjustment" from the IRS – the letter announcing the IRS's plan to disallow some tax position – have, *at that point*, gone out and purchased an insurance policy to cover the risk of an eventual assessment. How can this be? What risk or uncertainty remains at that point to be insured? In fact, there is plenty of uncertainty. There is still an appeals process within the IRS, and even if the taxpayer loses at the level of the appeals office, there is still the possibility of resorting to

the court system. At both of these levels, despite the fact that the audit has already occurred and the IRS has already announced its intention to contest a particular issue or set of issue, there is considerable uncertainty as to the final outcome; and that uncertainty can be insured. Insurance of this sort in other contexts is typically called “retroactive insurance,” as it is issued after a particular triggering event has occurred rather than before.⁵⁵ Obviously, the premiums are relatively high for such retroactive coverage, as the probability of an adverse decision is relatively high in comparison with standard liability insurance.⁵⁶ The same is true in the tax context.

Arguably the Most Famous Tax Insurance Policy

According to the proponents of tax transaction insurance, one of the reasons that tax insurance policies have recently become popular is that the IRS, perhaps because of recent reductions in its budget, have increasingly declined to provide advance rulings with respect to certain fact-intensive questions involving the application of uncertain anti-avoidance standards, issues, interestingly, that the Service had been willing to address in the past. One prominent example of this phenomenon both may help to explain why the tax insurance market has arisen now and illustrates the type of tax-transaction that generates the largest demand for tax indemnity insurance. The transaction in question occurred in 2001, when the Georgia Pacific Company wanted to split-off its timber operations in a transaction that would qualify for non-taxation under Internal Revenue Code section 355. In the split-off transaction, Georgia Pacific was, in effect, going to

⁵⁵ Retroactive insurance outside of the tax context is not common, but not unheard of either. The most famous example was the policy purchased by the MGM Grand hotel following the catastrophic fire at their facility that killed hundreds of people. A few months after the fire, after the company had been hit with over 450 lawsuits but when the size of the ultimate liability was still greatly in question, the owners of the property purchased a retroactive liability policy to cover the loss.

⁵⁶ MGM Grand paid \$39 million in premiums for \$170 million in retroactive coverage.

distribute its stock in a wholly owned subsidiary corporation (which subsidiary had substantially appreciated in value) to its (Georgia Pacific's) shareholders in exchange for their shares in Georgia Pacific. Without section 355, such a transaction would produce two levels of income tax: 1) tax at the corporate level to Georgia Pacific on what is effectively a sale of its subsidiary to its shareholders; and 2) a tax to the shareholders on the distribution of the shares in the subsidiary. Given the amount of appreciation that can be present in such a subsidiary, the resulting tax liability can be huge (and would have been so in this case), easily enough to make the transaction not worth doing. However, under section 355, such split-off transactions can be treated as a nontaxable event if certain requirements are met.⁵⁷ The problem is that one of the requirements is that the split-off be motivated by a substantial non-tax "business purpose," and cannot be merely a "device" for avoiding tax. The answer to the business purpose question, however, requires a very fact-intensive, ex post, uncertain, standard-like inquiry. In this particular case, the IRS declined to provide an advance ruling to Georgia Pacific because of the fact-intensive nature of the inquiry. As a result, there was a large amount of tax-related legal uncertainty in the transaction. In response, Georgia Pacific opted to purchase a tax insurance policy to cover the possible corporate-level tax, and the policy limits were set at \$500 million. With the insurance in place, the deal then went through.

Subsequent to this highly-publicized transaction, the IRS announced that it would no longer provide advance rulings on the business purpose part of proposed 355

⁵⁷ These sorts of corporate tax non-recognition provision can be understood as tax expenditures or as structural elements of the Code. Either way, and whatever you think of them as a tax policy matter, they are clearly intended by Congress to give special tax treatment to certain types of transactions. The question which transactions specifically should get this treatment, however, turns out to be one of those standards-type analyses that can only be handled ex post. (The decision by the Service not to issue advance rulings is effectively an admission of this fact.) Hence the source of legal uncertainty.

transactions.⁵⁸ The Service stated that the issue was too fact-intensive and would henceforth be resolved on audit. Thus, for 355-related transactions, corporate taxpayers are now left with the choice of forgoing the transactions, going ahead with the transaction and bearing the risk itself, or purchasing a tax indemnity policy. According to promoters of tax transaction insurance, it is precisely this sort of move by the Service that has led to the burgeoning market for their products. And indeed, many of the policies being written involve issues for which the IRS has been unwilling or especially slow to issue advance rulings. Thus, based on the tax indemnity policies that are currently being offered, one of their major functions seems to be a substitute for the certainty that might otherwise be provided by a favorable private letter ruling. Moreover, the Service's decision not to issue rulings in advance for these sorts of questions seems to confirm the idea that these are questions best settled ex post – after the transaction has been completed – via a legal standard. And tax insurance policies are one response to the resulting legal uncertainty.

IV. Assessing Tax Insurance (and Other Responses to Tax Law Uncertainty)

So what do we make of these new tax insurance policies? Obviously such insurance presents few if any consumer-protection issues, at least in comparison with tax-preparer warranties. Unlike the consumers in the return-preparation market, the consumers of tax transaction policies consist entirely of highly sophisticated taxpayers, mostly corporations, who are fully capable of taking care of themselves. The interesting question, then, is the tax-compliance one: Does the use of tax insurance policies pose a threat to the federal fisc? Will the spread of tax insurance worsen the problem of tax compliance by increasing the amount of evasion or aggressive/abusive avoidance? If so,

⁵⁸ Rev. Proc. 2003-48.

what is the appropriate regulatory response? Alternatively, does tax insurance serve socially beneficial risk-shifting function comparable to liability insurance? Or does tax insurance represent a novel form of privatized tax law enforcement, whereby commercial insurers step into the role once performed by the IRS? As it turns out, the answers to these questions depend largely on the differences between two different types of legal risk – what I have been calling *substantive legal uncertainty*, i.e., uncertainty as to what the substantive law is or how it will be applied to particular circumstances (which might also be “merits risk”) and *detection risk* (which in the tax context might be called “audit risk”).

Which is the Better Analogy: Criminal liability Insurance or Commercial General Liability Insurance?

Recall from the introduction the example of criminal liability insurance for white-collar crimes. I do not, of course, think that insurance companies are selling such insurance, whether for embezzlement or tax evasion or whatever. All of the policies I have seen include clear exclusions for fraud and other intentional legal breaches; and if they did not, the policies would be deemed void as against public policy and therefore unenforceable. What’s more, the bad publicity alone would dissuade any insurer from seriously considering offering criminal liability insurance of that sort. However, the *idea* of criminal liability insurance reveals some useful insights about the dangers of tax transaction insurance or of any type of liability insurance that can be interpreted to cover non-criminal regulatory violations.

First of all, it is obvious that criminal liability insurance (at least where the crime involves intentional law-breaking) would be a bad idea from society’s perspective. It is less obvious, however, why such policies should be made illegal (in the sense of void as

against public policy). Put differently, it is less clear why regulatory intervention is necessary to prevent such insurance from being sold. It is well known that insurance companies cannot profit from writing insurance coverage for intentional harms. For example, first-party insurance against the risk that an insured will burn his house down is not a risk that can be insured. In fact, it is not really a risk at all from the insured's perspective; it is simply a choice: will he torch the house or not. And (here's the rub) if he had an insurance policy in hand that covered the loss, the decision to burn the house would be much, much more likely. This is the classic example of moral hazard, and any insurance company that sold such a policy would soon go bankrupt. Thus, although there is also a public policy prohibition against intentional harm insurance generally, we probably do not need such a legal prohibition to prevent such policies from being sold.⁵⁹ So why do we need a legal prohibition against criminal activity insurance?

Criminal activity insurance, if it were not prohibited, could be a much bigger problem than intentional harm insurance – because it might in fact exist. That is, absent the prohibition (and assuming away the publicity problems⁰, insurance companies could actually profit from selling insurance against certain sorts of criminal activities, even those that involve intentional law-breaking. These would be crimes that involve a significant probabilistic element attributable to what I will call *detection risk*: the risk that the harm-producing action on the part of the insured (here, the criminal activity in question) will be detected and, if detected, attributed to (or pinned on) the insured. White collar crimes, including criminal tax evasion, would seem to fall into this class of crimes, as the probability of detection seems sufficiently low (and, again, probabilistic) to make

⁵⁹ This prohibition seems primarily expressive in nature, or perhaps intended to deal with the occasional case where the relevant intentional harm exclusion is poorly worded.

insurance at least theoretically possible. Although this type of insurance presents a huge social externality, it does not necessarily present an insurmountable moral hazard problem from and insurer's perspective. Of course, the insured may be somewhat less careful to avoid capture on account of the insurance (which would be the sort of standard moral hazard that would concern the insurer), but the large built-in deductible – namely, the possibility of uninsured jail time – would minimize such problems from the insurer's perspective. From a societal perspective, however, this arrangement could hardly be worse. What is in the insurer's as well as the insured's interest here is directly contrary to what is in society's interest. And that, presumably, is the main reason that criminal liability insurance should be and is not only unenforceable but [check this] a separate criminal offense itself.⁶⁰ The same could be said of insurance against criminal tax evasion, which clearly should and would be a violation of the public policy doctrine and hence unenforceable.

But what about insurance against tax liabilities that fall short of criminal evasion? A similar, though obviously less extreme, concern might be expressed about insurance against non-criminal tax liabilities. That is, the rise of the tax indemnity insurance market may put the interests of taxpayer/insureds and their insurers directly at odds with the interests of society. This would be true if tax risk policies were being sold primarily to cover detection risk or audit risk, rather than substantive legal uncertainty or merits risk. As is well known, the probability of any given taxpayer being audited is low and, due to reduced IRS funding, getting lower. Moreover, although most large corporations are audited more frequently (and some are, in effect, constantly under audit), the likelihood that any given questionable tax issue will be detected by the IRS is

⁶⁰ [would not criminal insurance constitute aiding and abetting?]

nevertheless exceedingly small, because the tax returns of such large corporations are so voluminous and complex. Couple that fact with the scandalously low existing penalties for tax underpayments, and it no mystery why taxpayers are willing to take very aggressive tax positions on their returns even without tax insurance. The audit lottery is a pretty good bet. The concern, then, is that the introduction of tax risk insurance might make an already serious deterrence or compliance problem even worse by eliminating the one deterrent that prevents some taxpayers from taking aggressive positions. Moreover, this effect could be significant if what currently keeps corporate taxpayers from being even more aggressive in pursuing tax avoidance opportunities is the risk aversion of corporate managers. That is, even if we are not worried about insurance against criminal tax evasion (because of the prohibition under state insurance law), we may well be worried that increasingly aggressive (though still risk averse) corporate taxpayers will, in effect, conspire with insurance companies to write policies that stop well short of insuring criminal conduct but that provide coverage for highly aggressive tax-shelter transactions – for which the only significant risk is audit risk, because the odds of winning on the merits approaches (but, again, does not quite reach) zero. That is, in the absence of some sort of regulatory intervention, it is at least conceivable that insurers could make a profit from selling tax-shelter insurance.

No one seems to disagree that the sale of tax-shelter insurance – or pure detection-risk insurance – would be a bad thing. And if tax indemnity policies are being sold to cover pure detection risk (that is, they are being written to cover shelter positions that are unlikely to be sustained on the merits), some sort of regulatory intervention by the Treasury Department or perhaps by Congress would almost certainly be a good idea.

Before we explore what such intervention might look like, however, let us consider how likely it is that insurers would in fact sell tax-shelter coverage. According to the sellers of tax insurance policies, of course, they have no interest in selling tax shelter insurance. In their promotional materials, for example, tax insurers state emphatically that they do not insure tax shelters, which at least one such insurer defines (again, in its promotional materials) as transactions “for the principal purpose of obtaining a tax advantage.”⁶¹ These statements, of course, could be purely for the benefit of tax regulators. Before reaching such a cynical conclusion, however, it is worth noting that the policies themselves, at least the ones that I have seen and that I have seen described, cover tax transactions that do not fit the mold for a quintessential abusive corporate tax shelter of the sort that has received attention recently in the tax and general business press. For example, consider the run-of-the-mill 355 spinoffs of the sort described in Part ___ above. Although there is clearly some risk that such transactions will be disallowed under existing anti-avoidance doctrines for lacking, say, the requisite non-tax business purpose, one would have to admit that such cases present genuine legal uncertainty or merits risk as well as detection risk. The same could be said of many of the corporate reorganization transactions (such as those under I.R.C. section 368), that have become the bread-and-butter work of corporate tax lawyers and that, despite presenting some prospect of disallowance (indeed, if there were no such prospect, the tax lawyers would not be needed), are not certain, or even nearly certain, to be struck down on merits if detected on audit. These transactions too are now being insured.⁶² And there are many other routine acquisitions and disposition transactions that are being insured that do not involve the

⁶¹ The Hartford and Lloyds materials

⁶² cites

sorts of transactions that are of greatest concern to the Treasury Department.⁶³ Certainly none of the examples of transactions that have been reported as being insured are the sorts of transactions (or are substantially similar to the sorts of transactions) that appear on the IRS's official list of targeted shelter transactions.⁶⁴ Moreover, with the insurance that is being offered, it is easy to see an element of substantive legal uncertainty that could be a substantial cause of concern, either because they call for the application of vague anti-avoidance standards (such as business purpose) or because they call for the application of highly complex rules to highly complex factual situations under circumstances in which time is of the essence to the deals.⁶⁵ In addition, as discussed above, at least some of the tax risk policies seem to involve virtually no uncertainty as to detection (and thus *only* merits risk), as the insurance is purchased *after* a ruling request has been submitted to the Service, and hence after the probability of detection on audit has been increased to one.⁶⁶

Again, one could object to the insurance in these cases on the ground that we would indeed like to discourage all such transactions, even the ones that present no merits risk, on the theory that the provisions themselves are bad tax policy. That, however, would not be a compelling argument against allowing insurance, but would rather be an argument for lobbying Congress to change the rules.⁶⁷ Another objection is that,

⁶³ Provide more exhaustive list: including 351 transactions, purchases involving section 29 fuel credits, like kind exchanges, threatened imposition of accumulated earnings tax under 531, etc.

⁶⁴ cite to most current list.

⁶⁵ The Georgia Pacific 355 spin off would be an example of the vague standards problem. The applicability of section 29 fuel credits would be an example of the factual complexity problem.

⁶⁶ Is this true? That is, does submitting a ruling request increase probability of detection of questionable transaction to 100%, or instead are there so many ruling requests that some things can still slip by?

⁶⁷ It is of course possible to tell a pessimistic public-choice story along the following lines: Once such provisions are enacted they can never be repealed, as interest groups form to support their retention and the disorganized mass of taxpayers is helpless to respond; and thus the only available, albeit second-best, option is discourage any use of these provisions through increase legal uncertainty. The conclusion is that

although insurers may not be advertising their tax shelter insurance policies, they may be selling them in secret and requiring confidentiality agreements to boot. Or, alternatively, if shelter insurance is not currently being offered, it is only a matter of time before it will be, as aggressive and sophisticated taxpayers put their heads together with aggressive and sophisticated insurers to push the limits of this new coverage. This is certainly possible. However, there are reasons to expect that (a) secret (confidential) shelter insurance is highly unlikely and (b) there are already in place factors that will limit how far taxpayers and insurers will go in insuring aggressive tax positions. For one thing, as my colleagues who work in the insurance field will confirm, insurance companies are famously (perhaps notoriously) conservative in their willingness to innovate aggressively in this way. Moreover, even if insurers were to become more aggressive on this front, there is always the threat of Treasury Department intervention. Indeed, it is the current position of the Treasury Department that tax risk insurance is not a compliance threat, but that the Department will continue to monitor the market for signs of abuse.⁶⁸

In addition, an argument can be made that, even if one function of tax insurance is the coverage of detection or audit risk (which seems almost certainly the case for many of the policies), so long as that is not the *only* function of tax insurance (that is, so long as there is also some substantial element of legal uncertainty being covered), then the better

tax insurance should not be allowed. One practical problem with such a response would be its imprecision: that is, to disallow all tax insurance could be wildly over-inclusive, as at least some of the tax uncertainty may not be desirable. Rather, it would make more sense to try to identify which specific provisions present the biggest problems and target those. If we do that, however, we might as well repeal or amend the provisions, rather than tinker with rules regarding insurance for the use of such provisions.

⁶⁸ Cite to final regs 1.6011-4. Even without the threat of Treasury intervention, it is possible that the demand for tax-shelter insurance may be dampened by the possibility that such a policy might be ruled void as against public policy under state insurance law. I doubt, however, that this would be a significant factor, because it is not clear who would raise the issue. The insurer probably would not want to do so, for reputational reasons. (It hurts your business reputation in the insurance industry if you sell a policy and then turn around and argue that the policy is unenforceable.) And no one else, other than perhaps the state insurance regulator, would have standing to do so.

analogy is not criminal liability insurance but run-of-the-mill commercial or professional liability insurance. With criminal liability insurance, the *only* risk was detection risk. In one sense, that is the problem with such insurance: there is no question that the insured event is illegal. There is no legal uncertainty. With run-of-the-mill liability insurance, by contrast, there is both detection risk and substantive legal risk. Put differently, the problem of low probability of detection is almost certainly not unique to tax law. For example, in the medical malpractice setting, there have been a number of widely publicized empirical studies indicating that only a small fraction of the injuries caused by medical malpractice result in claims.⁶⁹ I suspect a similar conclusion could be drawn about legal malpractice and many other types of tort-related injuries, although there is little reliable evidence on the issue. However, if this observation is true, then one could say that there is a sort of audit lottery for potential tortfeasors. Thus, for example, a doctor or lawyer could opt to take less than reasonable care in providing her services to a patient or client (and presumably save money in the process), but that would entail taking the chance of causing a harm that might eventually result in a tort claim. And yet, despite the existence of this type of legal lottery, we do not hear calls to ban or limit the purchase of medical or legal malpractice insurance or of liability insurance generally.⁷⁰ Thus, perhaps the better analogy is between tax insurance and regular liability insurance. And although the availability of liability insurance may create a sort of social externality (by, that is, dulling the *ex ante* incentive effect of tort law), we apparently have decided that

⁶⁹ cites

⁷⁰ Indeed, every liability policy covers some mixture of what is akin to merits risk (the likelihood that the insured will run afoul of some legal standard and thereby cause some harm) and audit risk (the likelihood that the injured party will actually file a lawsuit against the insured). Alternatively, one could think of the merits risk as being only the likelihood that the insured will run afoul of the legal standard, with the audit risk being both whether harm occurs and whether suit is brought.

this marginal decrease in incentives to avoid accidents is outweighed by the risk-shifting advantages of liability insurance.⁷¹ Indeed, to take this analogy further, perhaps tax liability insurance should be not only allowed but encouraged. In fact, as with the purchase of liability insurance generally, a case can be made that tax insurance actually enhances the enforcement of legal norms, as the insurers are enlisted to serve as privatized regulators of sorts and, because their money is at stake, have an incentive to make sure that insureds minimize risks.

The problem is that the tax insurance/commercial liability insurance analogy is not perfect either. One obvious difference is that there may be less of an underlying deterrence or compliance problem in the tort setting. This would be true if the size of the potential tort awards, including punitives, were large enough to offset the low probability of detection mentioned above. Indeed, the claim is sometimes made that the damages in the torts field are excessive (although the evidence to support this claim is dubious). In the tax context, by contrast, we have already noted that penalties for noncompliance, even for intentional non-compliance, are scandalously low. But that difference – stiff penalties in the tort context and trivial penalties in the tax context – do not obviously imply that the appropriate regulatory response would be to ban or limit liability insurance in the latter case and encourage it in the former. If the problem is that tax penalties are too low given the low probability of detecting tax noncompliance, the appropriate remedy would be either to increase the tax penalties to offset the low probability of detection (the audit lottery) or to increase the number of auditors and the resources available to them to raise

⁷¹ The other advantage of liability insurance, and this may be an important difference with tax insurance, is that liability coverage is sometimes considered necessary to ensure that injured tort victims receive compensation. That is, liability insurance can help to overcome the judgment proof defendant problem, although, if that is the motivation, then the coverage needs to be compulsory, as the judgment proof defendant will have an incentive to purchase too little coverage.

the probability of detection or both. Still, I am sympathetic to the argument that there is something unusual, even unique, about tax law. That is, I can understand one might conclude that compliance with legal standards is a bigger problem in the tax area than elsewhere. Having for years been a teacher of the introductory federal income tax course, for example, I can attest to the persistent notion among my students (and, apparently, among their parents) that there is something akin to a “natural right” to structure one’s affairs in whatever way minimizes one’s tax liability, so long as it does not violate the letter of the law. And I am pretty sure that aggressive non-compliance with the tax laws would generally be considered less of an affront to human decency that would aggressive non-compliance with, say, consumer product safety laws or the standards of medical practice. Yet I want to resist a tax-exceptionalist explanation of the need for regulating tax insurance, unless I can identify something unique about the tax-compliance problem (besides the facts that penalties and the probability of detection are too low). Moreover, even if tax non-compliance is more socially acceptable than some other types of legal non-compliance, it would, again, seem odd to respond by limiting insurance rather than increasing penalties and audit rates or mounting an educational campaign to change the way Americans view the tax system.

The Disclosure Solution

Having said all of this, there seems to be a relatively simple regulatory solution to the problem of tax risk insurance – a solution that (a) addresses the concern that tax insurance may be sold to cover especially aggressive transactions in which the only substantial risk is audit risk (a concern that I ultimately share) but (b) permits the sale of tax insurance to cover merits risk. This solution involves disclosure. That is, taxpayers

who purchase a tax indemnity insurance policy to cover a particular tax transaction could be required to attach a copy of the insurance policy to their tax return. They could also be required to file another form that would explain the nature of the transaction being insured (comparable to Form 8886 for so-called “reportable transactions”); however, such a form may not be necessary, as the tax transaction policies themselves typically contain a detailed description of the transaction and the tax treatment being insured. (Indeed, such a detailed description is essential to the insurer’s ability to underwrite the policy.) Then the IRS, if it determined that the transaction in question warranted auditing, could do so. Surely under such a regime the audit-lottery aspect of the insurance would be substantially reduced. And yet, if taxpayers find themselves being inhibited from engaging in a transaction, or find themselves otherwise being induced to “over-comply” with the tax laws, purely as a result of merits risk, they can purchase tax indemnity insurance. They just have to disclose it.

Interestingly, a form of this idea was considered by the Treasury Department and was included in one version of the temporary regulations dealing with “reportable” transactions. That is, under the temporary regs, the purchase of tax indemnity insurance was to trigger a requirement to file a “Reportable Transaction Disclosure Statement.” Perhaps unsurprisingly, the insurance industry responded with negative comments, arguing that this reporting requirement would have a “chilling effect” on the tax insurance industry and thereby harm the economy, as, on their view, tax insurance was becoming a useful substitute for advance letter rulings and was thus important to continued mergers and acquisitions activity.⁷² They argued further that tax insurance was not being sold for shelter transactions, was only being sold to risk averse taxpayers who

⁷² Comments by Dave De Berry of The Hartford (published in Tax Notes)

are concerned primarily about (to use my taxonomy) merits risk, and had the effect of improving tax compliance because only the most conservative tax positions would survive the insurers' underwriting processes. They did, however, concede that part of the risk being insured was audit risk. Thus, they argued that a disclosure requirement would make taxpayers view tax insurance policies as increasing rather than decreasing their risks, at least with respect to the deductibles. But of course, that increase in risk of *detection* would be, from a social perspective, a good thing. And if an increased detection risk is of substantial concern to taxpayers, it calls into question whether what is primarily being insured is merits risk. Put differently, the chilling effect associated with a reporting requirement for tax insurance policies may deter precisely the types of tax insurance transactions that we are most concerned about. And if, after the adoption of a reporting requirement, the tax insurance market were to "dry up" completely, and insurers and taxpayers were not able to negotiate policies in ways that made them profitable for both sides, that would provide fairly convincing evidence that these products are providing more coverage for detection risk than merits risk.

To date, the insurance industry has persuaded Treasury that tax insurance is not a problem. Under the current reportable-transaction regulations, the purchase of tax insurance is not grounds for reporting.⁷³ It is interesting to note, however, that other forms of "contractual protection" – such as tax-advisor money-back warranties – do trigger the reporting requirement. That is, if the insurance is provided by the tax advisor rather than by a separate insurance company, and if the insurance is limited to a refund of fees in the event that the tax position in question is rejected, then the taxpayer must flag

⁷³ 1.6011-4.

the transaction for the Service.⁷⁴ The exception to this rule is when the tax advice being given, and the money-back guarantee being provided, involves a claim for refund based on a return that was already filed prior to any fees being charged. Obviously, then, the concern here is that such guarantees (or contingent-fee arrangements) will be used to cover mostly detection risk (i.e., aggressive shelter opinions), except in cases involving refund claims, where the probability of detection is already one. The interesting question is why this concern about detection-risk or shelter insurance would be greater for tax-advisor warranties and contingent-fee arrangements than for tax insurance policies. Presumably, the answer, if there is an answer, lies in the nature of the two markets. With the involvement of third-party insurance companies, we introduce an element of objectivity as well as a regulatory structure – that is, the state insurance regulatory apparatus, including the possibility of invoking the public policy doctrine. Plus the fact that insurance companies are traditionally conservative by nature. By contrast, with contingent-fee arrangements, the same enterprising tax advisors who are helping to drive the shelter market may be more than willing to gamble their fees on the audit lottery, especially because they are confident that their opinion letters will at least enable the taxpayers to avoid penalties – and the tax-guarantee may be tied only to such penalties. [Think more about this.]

IRS as Legal Uncertainty Insurer?

[Here insert section discussing comparison between private tax insurance and IRS advance rulings. Consider possibility of IRS selling rulings for a premium. Advantages: save on administrative cost; IRS has comparative advantage in terms of knowledge of

⁷⁴ See supra note 44.

how it will interpret law; presumably could underprice commercial insurers.

Disadvantages: Changes job of IRS; public perception problem of IRS “selling tax loopholes”; competitive market for insurance may be better.]

[Write Conclusion]